Chapter 9

From Interdependence to Vulnerability: EU-Russia Relations in Finance

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Since 2014 Western sanctions have been primarily designed to exert influence through the Russian financial system. On the microeconomic level, measures were taken to freeze the Western assets of Russian senior decision-makers and entities. On the macroeconomic level, a wide variety of restrictions were imposed, most of them as a response to the escalating conflict in eastern Ukraine: the EU limited trade in certain financial instruments with a maturity longer than 90 days; the US introduced various transactional bans on major Russian companies, such as Rosneft, Novatek and Gazprombank. Especially in these latter cases, the underlying expectation was to reduce the liquidity of Russian economic actors, hamper their investment potential and consequently constrain Moscow's economic potential in the short and medium run. On the macroeconomic level, stringency was meant to affect a wide range of sectors indirectly and proportionally, while financial sanctions on individuals caused targeted pain for decision-makers.

The objective of this chapter is to summarise and briefly analyse the transformation process of Moscow's financial interdependence with the West and the EU, and in particular Russia's vulnerability. At the level of investments and financial and payments systems there was a much larger development cleavage in 2014 than in EU-Russia trade or energy relations. For the West and especially for the EU, this was the first time that economic statecraft had been used as the central element of its policy towards Russia. For Russia, integration into global value chains became a persistent threat to its sovereignty, forcing it to securitise new segments of its economy and develop new forms of resilience. Consequently, previous cooperation and interdependence moved into a new context, changing their patterns considerably.

In the first part I look briefly at the 2014 sanctions in the context of financial systems and highlight the differences between the EU and US approaches. This part also maps out the potential limits of sanctions policy, if inconsistencies within transatlantic relations remain, implicitly demonstrating the EU's significance in Western sanctions policy. In the two subsequent sections I look at two issues. First, I analyse the implications for Russia of the existing Western sanctions, especially regarding the capital account, FDI and Russia's net financing position. Second, I make a short presentation on Moscow's policies, notably its efforts to increase the resilience of its payments system, which represent its most tangible reaction to the new reality. Increasing sovereignty over payments systems is also about lessening the consequences of a potential new round of Western sanctions, thus systematically and implicitly broadening future Russian foreign-policy options. In both of these issues I focus on the momentum of change, comparing the situation before and after 2014s and pointing to potential further trajectories. Finally, the concluding section briefly explores prospects for the future.

Power Relations of Western Sanctions

Before exploring the shifts in EU-Russia interdependence, it is important to look at the power relations of the Western sanctions policy. Due to the key importance of the US in this issue, it is necessary to briefly compare the EU's sanctions with those of the US. The Western sanctions against Russia constitute an extremely diverse set, in terms of both subjects and targeted fields. The EU and the US, the two leading entities of Western sanctions policy (in total, 37 countries have imposed sanctions on Russia), coordinated their measures, especially in the early years, in order to optimise their impact. Despite these efforts, US and EU sanctions policies differ considerably.

First, the US has a long record of and considerable capability to impose and implement sanctions. In the 20th century, on 109 occasions out of 174 documented cases it was the US that deployed sanctions, while the EU used this instrument only 14 times.[1] Washington has developed capabilities to monitor subjects, follow their actions and enforce its claims. The internal legal procedure has crystallised, and tactical issues are managed with high proficiency and efficiency. The EU has also intensified its sanctions policy in the last 20 years. At the same time, its policy still relies heavily on the 28 member states in both the decision-making process and implementation. Unlike the US, where the lifting of current measures often requires a long and laborious process in Congress, the European Council must renew even the existing set of sanctions each year. Enforcement depends on national authorities and this sometimes offers major loopholes for targeted subjects.

Second, US sanctions are often enforceable beyond its national borders, even in cases in which the banned transaction takes place between two non-US subjects. This is especially true for sanctions related to the global financial system. Given the US role in global banking and the US dollar's role in global finance, almost all major entities have US affiliations. Thus, Washington can compel even banks and countries that do not formally accept US financial sanctions to impose them on Russia or at least to consider the US legal threat on their transactions.[2] In this way, Washington can constrain Russian financial cooperation even with Chinese or other Far Eastern

[1] Hufbauer et al., 2009, pp. 3–5.

[2] Société Générale, 2018.

subjects.[3] This is a major advantage, enlarging the scope of its actions and making the EU's measures appear rather weak.

Third, the objectives of US sanctions go well beyond the Ukraine conflict. While the EU pursues an issue-based approach, Washington formulated a diverse set of goals related to cybersecurity, human rights, Russian action in Syria and Russian energy policy.[4] US sanctions against Russia have become normative and a continuous process, with little hope for Moscow of changing them substantially. This is in sharp contrast to EU-Russia relations, in which Russia may anticipate a status quo attitude unless Moscow changes its own policy. It may even try to water down the current set of sanctions, especially if it can shift the Western perception of its actions in eastern Ukraine or reach significant compromise on the issue.

Given these features, it is reasonable to say that the US leads on Western sanctions policy. US measures have a broader scope and provide certainty that current sanctions will be present for a long time and also uncertainty about what comes next. The latter is pivotal for any effective sanctions policy. The notion of worsening relations and future actions handicaps longer-term patterns of cooperation, increases country and corporate risks, and makes external financing considerably more expensive for banks and financial institutions. The EU's participation was important at the start and still provides a good deal of weight and international credibility. At the same time, its measures are too stagnant with little potential for change, enabling targeted subjects to adapt to them. EU decision-making obviously suffers shortcomings stemming from its intergovernmental nature. Unlike the US, European companies are also much more affected by Russia's economic difficulties, significantly constraining the EU's scope for action.

[3] A good demonstration of this was the arrest of Huawei's chief financial officer in Canada in December 2018 and her potential extradiction to the US because of the alleged violation of US sanctions against Iran.

[4] Liik, 2019b.

When looking at EU-Russia interdependence at the level of financial systems, these characteristics must be taken into account. Despite all the damage to political and public trust caused by Russia's actions against Ukraine, EU sanctions against Russia remain reversible. However, much of the damage to EU-Russia ties stems from US sanctions on their own. The potential implications of an EU "sanctions thaw" may be limited if US sanctions remain in force. Nonetheless, the political-economic context of sanctions has been changing. Given the extensive use of sanctions policy by the Trump administration and international discontent over dismantling certain multilateral institutions (e.g. the WTO dispute settlement process), even the EU may distance itself from the US. Washington has to some extent discredited its leading role in the global economy, putting the creation of alternative systems on the agenda in many countries.[5] Russia's attempts to regain autonomy over its own payments systems and strengthen financial resilience are therefore to some extent in line with the economic zeitgeist.

How the Sanctions Work

Shrinking turnover between the EU and Russia

The impact of sanctions on Russia's economy was magnified by two major factors: a fall in oil prices from the summer of 2014 and a general slowdown in GDP growth caused by structural problems since 2012. Russia went into recession after 2014 and has been recovering sluggishly since 2016. All these signs could be interpreted as symptoms of major growth problems. At the same time, it is impossible to measure to what extent this is due to Western sanctions. Some assumptions regarding the long-term macroeconomic effects can be drawn by approaching this issue from the balance of payments angle, analysing its interaction with other countries.

5 For example, even senior German politicians support the idea of creating a "European SWIFT", given the alleged US bias in the current system.

Being a major energy exporter, Russia traditionally has a huge foreign trade surplus (180.6 billion USD and 115.4 bn USD in 2013 and 2017 respectively).[6] Exports constitute by far the biggest line in the current account balance (521.8 bn USD and 353.6 bn USD) and have been only negligibly affected by the sanctions; the measures directly targeting the energy sector are very limited and their effects can be felt only in the longer run. On the imports side, sanctions may have triggered some indirect effects. Western sanctions influenced the rouble's exchange rate, and the political threat may also force Moscow to restrict imports for a variety of reasons. Nonetheless, falling oil prices have caused steady depreciations of the rouble in the past, especially in 1998 and 2008–9. It is therefore reasonable to say that a foreign trade surplus is a systematic feature of the contemporary Russian reality and gives a good deal of robustness to its finances.

Other lines in the current account have traditionally been negative and reduce the surplus. These items have presumably been affected to a greater extent by Western sanctions. Among others, they include foreign exchange in services (–58.3 bn USD and –31.1 bn USD in 2013 and 2017 respectively), compensation of employees (–13.2 bn USD and –2.3 bn USD) and investment income (–66.5 bn USD and –39.8 bn USD). The latter line in particular is increasingly sensitive to expectations about the future. Nevertheless, Russia's current account balance remained positive (1.4% and 2.2% of GDP in 2013 and 2017 respectively) and it would be difficult to characterise these developments as unique or out of the ordinary.

The emerging perception of Russia's financial vulnerability is more visible in the capital account. This shows the net lender–borrower position of a country, including direct investments, loans and balances of other transfers between domestic and foreign subjects. This turnover has dropped substantially, the annual growth of liabilities

[6] Data in this chapter come from the Central Bank of the Russian Federation (CBR) unless otherwise stated.

decreasing from 124.4 bn USD to 1.3 bn USD between 2013 and 2017.[7] Given the similar trajectory of Russia's external assets, this signals a major drop in financial interaction between Russia and the rest of the world. While Russia remained a net lender to the rest of the world, capital transactions fell to a qualitatively new level. On the one hand, Russian subjects refrained from capital transfers abroad, where the threat of existing and future sanctions may have played a significant role. On the other, Russian residents also stopped receiving capital transfers from abroad. Besides FDI, this also affects the level of foreign debt, which decreased from 715.9 bn USD to 470.2 bn USD between January 2014 and October 2018. This latter indicator is a major change in the trend and is certainly an effect of the sanctions, and signals an inability and to some extent unwillingness to borrow from abroad.

The reduction in gross capital transfers only implies a more "closed" status of the economy and does not ultimately affect economic performance. Nonetheless, it may cause major turbulence even in the short run if other lines of the current account balance change unfavourably. Thus, positive balance in Russian exports and especially international oil and gas prices may have an even greater significance today than in the past. In order to improve the short- and medium-term effectiveness of sanctions, a major reduction in export revenues would have been not only desirable but essential. This happened only partially, due to market forces (the average export price of Russian Urals oil fell from 106.9 USD to 40.3 USD/barrel between 2013 and 2016). Limiting foreign trade and especially putting a direct or indirect embargo on Russian energy has not been among the West's policy options. Restricting the capital account was the maximum affordable at the current level of the dispute.

Nonetheless, in the longer run the low principal of the capital account may turn out to be expensive in the macroeconomic sense. High levels

[7] In 2015 this figure was −72.9 bn USD, against a 4.0 bn USD decrease in Russia's foreign assets.

of FDI represent not only financial but also technological and know-how transfer for the recipient economy. The lack of these may slow down technological progress, especially if not compensated for by other, domestic efforts. A lack of external finance may have worrying consequences, given the capital-poor nature of the Russian economy and the capital-intensive energy sectors. Major Russian companies cannot raise the funds needed for their development projects from domestic sources, and can therefore only get foreign credits at higher interest rates or less favourable terms.

The end of the decade of Russian iFDI?

In formal terms, investments are not inherently a part of finance. Nonetheless, high levels of inward foreign direct investment (iFDI) often symbolise the ultimate form of economic trust between subjects and are very sensitive to any disruptions in relations. It should therefore be no surprise that annual flows of iFDI to Russia fell by more than 90% between 2013 and 2015.[8] This fall by far exceeded the drop in any other category, such as foreign trade, outward foreign direct investment (oFDI) from Russia, and remittances. This collapse also affected EU-Russia relations, since the Union had a unique role among foreign investors: at its peak, the EU's share of total iFDI in Russia was over 80%. This is a very high proportion, even if investment flows from Russian-owned foreign residences (e.g. round-tripping and transhipping) represent a major bias in interpretation.

In a post-communist new EU member country, such a gap in FDI flows would have caused severe recession and, probably, political turbulence. But for Russia, iFDI and multinational companies have never become such important strategic constituencies as in most EU member states. According to UNCTAD, until the mid-2000s Russian iFDI stock levels

[8] From 69.2 bn USD in 2013 to 6.8 bn USD in 2015. For comparison, iFDI flows decreased to a much more humble level during the financial crisis, from 74.8 bn USD in 2008 to 36.6 bn USD in 2009.

remained below those of the combined Visegrád Four countries, even in absolute terms.[9] Thus, expansion of foreign investments started relatively late, in the mid-2000s, and lasted only for a decade. The reasons are manifold. Besides the long and turbulent transformation under Yeltsin and late consolidation in the early Putin years, Russian FDI receptivity always remained relatively low. According to the OECD's FDI Regulatory Restrictiveness Index, the Russian indicator exceeded the OECD average by a factor of almost three (0.182 vs 0.066).[10]

Furthermore, foreign multinationals were driven into Russia by different motivations than they were in Central and Eastern Europe. In the new EU member countries efficiency-seeking and access to the region's cheap and educated labour force for manufacturing industries was the major incentive. At the same time, in the case of Russia, market- and resource-seeking motivations played a dominant role. Having the 9th-biggest population in the world and being 48th on a per capita GDP PPP basis,[11] Russian aggregate demand is comparable with all former communist Eastern European countries combined. Foreign multinationals understandably tried to access this market and, given its economies of scale, they were also ready to bring in production capacity to supply local demand. Thus, European iFDI in sectors such as car assembly, pharmaceuticals and the food industry targeted not export markets so much as Russian consumers. Similarly, access to huge and often cheap resources in sectors like energy, mining, forestry and agriculture has remained a major objective, despite local policy constraints.

However, these investment motivations are increasingly sensitive to growth and political considerations. For solid market-seeking

[9] The average per capita iFDI of Russia and the combined V4 (Czech Republic, Hungary, Poland and Slovakia) between 2005 and 2009 remained at 2,057 USD and 5,659 USD respectively (author's calculations based on UNCTAD FDI data).

[10] OECD, 2017.

[11] Author's ranking based on data from the IMF World Economic Outlook Database 2018. IMF, 2017.

investments, the prospect of long-term sustainable growth in aggregate demand is crucial. These prospects were taken for granted in the past, since Putin's legitimacy rested partly on spectacular growth in welfare and social stability. On this basis, politics was to some extent overlooked as a potential threat to local business. The annexation of Crimea and the subsequent Western sanctions constituted a major watershed in this respect, driving Russia into recession and putting political risks into the spotlight of business activity. Similarly, Russia's move towards import-substitution, reliance on local resources and a large number of new restrictions further constrain resource-seeking investments. This latter feature has been present since the mid-2000s, but since 2014 related country risks have deteriorated considerably.[12]

However, Russian iFDI levels are historically closely interrelated with the respective flows of oFDI. This has long been a distinctive feature of Russia among the BRIC countries. Capital exports and outflow were increasingly motivated by local push factors, the low level of financial services and institutional uncertainties within Russia. A good deal of these funds returns to Russia through foreign residency: in 2017 the top three investor countries in Russia were Cyprus, the Bahamas and Luxembourg, with a combined share of 64% of total iFDI. Western sanctions may considerably encumber these round-tripping and circulation activities. Under most sanctions regimes, foreign banks and financial entities must examine every suspicious transfer on the basis of ultimate beneficiary ownership. This is a complicated administrative process with a high probability of failure, especially if the client is related to the extensive web of sanctioned individuals or entities. Under the US sanctions, even financial transactions with some major Russian companies may hold certain risk.

[12] Traditionally the law on strategic industries (Federal Law No. 57-FZ of April 2008) is taken as the formal start of cutting the list of sectors accessible to foreign investors (Russian Federation, 2008). However, informal political support had been essential for major deals even before that, as the failed purchase of Yukos or the Sakhalin concessions demonstrated.

It should therefore come as no surprise that many European banks refrained from major financial transactions with any Russian subjects, especially in the early years of sanctions, and those that ran the risk did so probably at fees higher than normal. Understandably, regulations and practices vary widely between countries and banking institutions. Nonetheless, multiple transfers of funds, often required to hide traces of the client from Western and/or Russian governments, carry exponential risks and costs, restricting the scale of applicability. Unlike simple capital flows, round-tripping usually requires precisely these multiple transactions. Consequently, oFDI from Russia fell from 86.5 bn USD to 36.8 bn USD between 2013 and 2017.

Despite all these negative trends in FDI, there is hardly any indication of a change in the geography of investments. In 2016 Singapore became the largest foreign investor in Russia, but this was due to a single megadeal; Singapore's 3.7% of total iFDI stock is no match for Cyprus' share of 36.7%.[13] It would also be misleading to speak of a major investment gap in Russia. Capital investment fell from 23.1% of GDP to 21.9% between 2013 and 2015 but later recovered. The reduction in iFDI was probably offset to some extent by domestic investment, boosted by depreciation of the rouble. All these indicators suggest a degree of reversal of the trends since 2014. The major question, therefore, is whether the FDI gap is a temporary setback or represents a new form of economic model that relies predominantly on internal capital accumulation and successfully constrains round-tripping.

How Russia Has Adapted to Sanctions

Budgetary tightening and credit deleveraging

The conventional European expectation was that sanctions would restrict Moscow's financial capabilities, cause social and elite discontent

[13] CBR, n.d., table "Pryamiye investitsii v Rossiyskuyu Federatsiyu - 2018".

and thus force Russia to choose the lesser of two evils and make concessions in the conflict over Ukraine. While it remains unclear to what extent economic coercion is convertible into foreign policy, the scope of the financial tightening is worth analysing.

The Soviet Union and Russia faced several external economic shocks in the last 30 years. Falling oil prices combined with domestic weaknesses caused severe financial problems in 1986, 1998 and to a lesser extent 2008–9. This is to some extent normal, given Russia's sharply increasing reliance on revenue from energy exports since the late Soviet period and liberalisation of its foreign economic relations after 1991.[14] Moscow failed to manage this trend of interdependence with global markets until the late 1990s. The incoming Putin administration did not change direction towards integration with the world economy, but set measures to manage future vulnerabilities and increase Russian financial self-rule. On the public finance level, Russia repaid much of its debt to foreign creditors and the IMF by 2003. It also set up an anti-cycle mechanism in its 2004 budget to collect excess rent income from oil and gas exports (the Stabilisation Fund) and splitting it between two quasi-sovereign wealth funds (the Reserve Fund and the National Welfare Fund) in 2008. The combined value of these funds equated to around 8% of GDP in early 2014.

Western sanctions did not affect public finances directly.[15] Sanctions may have aggravated economic hardship in Russia and vastly increased the risks of taking large-scale credits in foreign markets. Both these developments currently have little relevance, although

[14] In 1985, 14.7% of total Soviet hydrocarbon production (1.536 billion toe) was exported. In 2010 the respective figure for Russia was 47.1% (of 1.279 billion toe). Author's own calculations, based on Gustafson, 1989 and IEA "Country statistics".

[15] In early 2018, the US Department of the Treasury considered the usefulness of extending sanctions to Russian sovereign debt, but these measures would also have caused damage to US subjects and their effects seemed to be considerably less harmful without EU involvement. Timofeev, 2018, p. 24.

they may narrow Moscow's economic options in particular future situations. One of the factors deserving of attention is the depletion of Russian budgetary reserves. The roughly 90 bn USD in the Reserve Fund had been fully spent by early 2018,[16] by which time the government had started taking assets from the National Welfare Fund. Given that a good deal of the latter's resources was in illiquid form and invested in Russian projects, the total accessible funds approached a record low (2% of GDP). While this can be considered a normal anti-cycle policy, the threat of potentially low oil prices remains valid and forces the Kremlin to keep a tight hold of the budget. The second factor is global monetary tightening and rising interest rates, and their implications for emerging and commodity markets. This may further restrict Russian public and corporate borrowing, and lessens the chances for Russia to manage economic problems through growing indebtedness. Without fiscal buffers, Moscow can only balance public spending by cutting expenditure or raising taxes. Not surprisingly, it could not maintain the previous high levels of defence spending beyond 2017, and general government revenue in terms of GDP is expected to reach a new post-2009 high (35.5%). Cutting military spending and causing tight fiscal balances are among the stated objectives of Western sanctions policy.

The reserves of the Russian Central Bank (CBR) are of a different magnitude. In early 2014 they stood at 500 bn USD, more than one-fifth of Russia's GDP.[17] Unlike the budgetary reserves, the government makes efforts to preserve the CBR's funds as the country's main financial buffer. While it functions as a conventional monetary instrument, the CBR traditionally refrains from excessive interventions and allows the rouble to depreciate relatively early in crisis situations. This is in sharp contrast with the 1998 Russian crisis or the monetary policies of many other oil exporters. While this practice leads to the preservation

[16] Inozemtsev, 2018a.

[17] For comparison, at the time of Putin's inauguration in May 2000, the CBR's reserves were below 18 bn USD.

of CBR funds, it represents a major exchange rate risk for other economic subjects. The exchange rate with the euro fluctuated intensively – between 46 and 90 roubles – in the first two years of the Ukraine conflict, causing serious losses for unprotected companies.

Exchange rate volatility polarises the corporate sector's relationship with credit markets. Exporting industries, mainly from the mining sector, collect their revenues mostly in foreign currency and have high capital investment and borrowing requirements. For national flagship companies like Gazprom, Rosneft and Lukoil, the domestic credit markets are too shallow, so their search for foreign credit opportunities is natural. The Putin era brought a normative approximation in this respect, as Russian corporate actors introduced Western auditing, reporting and other standards in order to tap foreign financial markets. Other, usually smaller, firms and households receiving their revenues in roubles remained more dependent on national credit markets. The CBR and the government maintained a cautious approach to foreign-currency-nominated lending prior to 2014. Total Russian debt increased from 213.3 bn USD to 728.9 bn USD between 2005 and 2014, around 75% of it nominated in foreign currencies. By international standards, this level represents a low exposure, especially given the CBR's vast reserves.

The Western sanctions brought a turnaround even from this relatively low level. As mentioned earlier, Russia's foreign debt in absolute terms has decreased by 35% since January 2014. The fall was particularly steep in the first two years, when major Russian companies and banks withdrew from international credit markets: e.g. Gazprom did not issue eurobonds between February 2014 and November 2016 (between 2011 and 2013 it issued eight tranches of them). This deleveraging process can certainly be attributed to the sanctions. At the time of global quantitative easing and low interest rates, when cheap credits were particularly popular in emerging markets, deleveraging was somewhat exceptional. Since then, despite the return of many

Russian corporate entities to the credit markets and the lack of visible premium on interests, borrowing has remained very cautious and moderate deleveraging has continued.

Russian companies have also turned towards Far Eastern financial markets. Besides corporate risks in relation to the West, this move has also been underpinned by the gradually shifting geography of Russian exports and infrastructure. The first time major Chinese financial support was accepted by Russia was for the purchase of Yuganskneftegaz by Rosneft in 2005, an action which would have posed a huge legal risk for any Western entity. Since then these credit relationships have become widely used and since 2014 a new set of companies has joined the race for Chinese and Far Eastern connections. Sberbank started to lend in yuan, VTB and Bank of China set up new product lines servicing trade contracts, and Gazprom issued bonds for Asian lenders. Novatek went even further, by giving a major (29.9%) stake of its Yamal LNG project to Chinese investors. Russia and China are also attempting to switch from the US dollar to the yuan and rouble in bilateral trade.[18] Nonetheless, these shifts must be made with care: Chinese lending conditions are sometimes harsher than those from the EU, and Asian financial markets often lack liquidity and are in some respects underdeveloped. While these trends are natural in light of the shifting geography of the Russian economy, a rapid and full reorientation seems unlikely.

Establishing self-rule over the Russian payments system

While current Western sanctions only partly affected the payments system, in the last four years Russia has securitised this issue and set up a sovereign infrastructure. Many other countries developed some elements of their payments system in a similar way in the

[18] Only 18–19% of bilateral trade was conducted in roubles or yuan in 2017. This represents a fourfold increase compared to 2013, but further progress could be difficult (Dolgin, 2018).

past. Nonetheless, the Russian move seems unique, inasmuch as it is driven by security considerations and is aimed at increasing resilience in case of a further deterioration in foreign relations.

After the break-up of the Soviet Union, the Russian payments system developed in a liberalised manner. Emerging financial institutions joined the global, mostly Western, infrastructure without having an alternative or national strategy in this respect. The Russian payments system has been built up following business inertia, and domestic efforts were driven by emerging requirements from the corporate side. The 2008–9 financial crisis brought considerable shifts in this attitude. The crisis created a good deal of turbulence in the global financial and payments system, some of which could have been avoided, or at least reduced, by having some elements of payments infrastructure in national hands. These cases were related to stalling interbank markets and problems with payment cards. Consequently, the Russian government put a number of measures in place to increase resilience and laid the foundation of Russia's own payments system. In 2010 it decided to establish a national payments system servicing state entities and municipalities within the national border (without the involvement of non-Russian subjects). In 2011 a national bank card system (Universal Electronic Cards, or UEC) and the related infrastructure (PRO100) were created, offering an alternative to other systems, such as Visa and Mastercard.[19]

These measures offered a humble alternative to existing payments practices. The number of entities using and accepting these channels and cards remained limited. UEC was accepted only by 250,000 trading units, even including some major Russian banks. Furthermore, the service remained relatively expensive and slow, was accessible only within national borders, and issues over coordination with other providers remained unregulated. The policy objective, clearly, was rather to create an alternative with limited scope and effects for

[19] Arzumanova, 2017.

certain purposes, and not a substitute for the dominant forms of payments through international providers. The "Strategy on development of a national payment system" accepted by the CBR on March 2013 was prepared in this hybrid spirit.[20]

The strategy has changed with the introduction of Western sanctions. In the new situation, Western – especially US – authorities can even request data from international providers on the domestic financial transactions of sanctioned Russian individuals and entities. Furthermore, in March 2014 Mastercard and Visa stopped servicing some Russian banks, citing US sanctions, leaving 220,000 Russian citizens without access to their bank cards.[21] The extension of the sanctions became a realistic option, and discussions even began on disconnecting Russia from SWIFT. This latter potential step could almost completely paralyse economic cooperation with Russia, including trade in energy, causing severe disruption not only for Moscow but for all capitals having trade relations with it. Consequently, the Russian government decided to establish a new national payments system with the capability to substitute international payment providers as much as possible.

Under the new system, all domestic financial institutions are obliged to open accounts at the CBR, through which their transactions within Russia are serviced; all information is classified and it is forbidden to provide data to any outsiders. At the same time, all domestic payments by any bank cards, including Visa and Mastercard, are serviced within Russia through the National Payment Card System. Russia also created its own bank card payment provider, a system known as MIR. By October 2018, 45 million cards had been issued, a 17% market share.[22] MIR is accepted by all major Russian banks and companies. Several measures have been taken to secure accessibility of MIR cards abroad at reasonable cost. Cooperation with other

[20] Ibid.

[21] Ibid, p. 133.

[22] National Payment Card System, 2018.

international providers, such as Mastercard, Visa and China UnionPay, has been arranged through partnership programmes since 2016, while Russian banks also offer co-badging cards (e.g. MIR-Maestro). The latter function as MIR cards within Russia and in line with the standards of the co-badging partner abroad. However, the policy objective is to get recognition abroad for MIR in its own right, and this has been achieved in some EAEU countries (Belarus, Armenia), and potentially, in the foreseeable future, even beyond (e.g. Turkey).[23]

While the Russian authorities understandably prioritise the new national payments system, it still has some shortcomings. It applies higher fees than its competitors, and affiliated services such as a clearing solution have only recently been established. Nonetheless, past examples show that national payments systems have relevance and can play an important role at national or even international level. Japan established its JCB International in 1981, and now has around 111 million credit card users worldwide. China introduced UnionPay in 2002 and India has had RuPay since 2012. As far as national bank cards are concerned, even European countries apply different schemes, such as Carte Bleue in France, the Girocard debit card system in Germany and Bancomat in Italy. MIR and related payments systems could certainly evolve as a major stakeholder in Russia and in some neighbouring countries.

At the same time, even these new systems hide vulnerabilities. Transactions, especially with European or US entities, remain "visible" and detachable through the accounts of both the respective banks and Western financial providers. The likelihood of Western banks joining MIR in the foreseeable future remains low. Furthermore, the SWIFT system, providing technical support for global transactions, remains a major source of vulnerability for the whole payments system. Even if SWIFT is legally a Belgian company, it is widely alleged

[23] National Payment Card System, n.d.

that the US authorities can access its systems and even block transactions in US dollars. On these grounds, senior European stakeholders such as Federica Mogherini, the EU's High Representative for Foreign Affairs and Security Policy, and the German foreign minister, Heiko Maas, have expressed their wish to establish the "EU's own SWIFT" to achieve independence from the US.[24] Accordingly, Russian stakeholders strive for de-dollarisation of their transactions (e.g. Gazprom has reportedly switched from US dollars to euros in many of its European export contracts) and actively advertise their readiness to establish an alternative to SWIFT. Countries potentially affected by Western sanctions, especially Iran and Turkey, but even China, may also be interested in this. Nonetheless, given the sensitive nature of this information and its significance in global financial governance, no easy progress is to be expected.

Conclusion

Since the break-up of the Soviet Union, Russia had been integrating into the global financial system, established and developed in the Western hemisphere after World War II. This system has been historically dominated by the leading role of the US and its currency. Nonetheless, due to its extensive trade, human and political relations with European countries, the EU also won a major role in Russian investment, banking and credit. The Western sanctions introduced since 2014 represent an important turning point in this respect. Representatives of European and Russian business can no longer ignore political components: these risks must be included in corporate strategies. While this process is not irreversible, in terms of mutual investment the period of rapprochement is over and it may take a long time to rebuild trust.

[24] Maas, 2018.

The effects of political disputes and sanctions will be magnified by a number of underlying structural trends. Russia has been distancing itself from the EU in terms of foreign trade for more than a decade. In 2005, the EU and APEC respectively accounted for 52.0% and 16.2% of Russia's foreign turnover, while in 2017 these indicators were 42.8% and 29.9% respectively. Given planned and ongoing energy projects, it is reasonable to expect near parity proportions between the two economic blocs in the foreseeable future. This happens more as a result of normal market gravity than on the basis of political assumptions, and indicates a major change in trade orientation. Protectionism and import substitution gained popularity long before 2014. Russia's accession to the WTO in 2012 signalled a major, but clearly last, step in Russia's post-1991 liberalisation. In many respects, protectionism provides opportunities for social and elite consolidation, even if potentially at the cost of sacrifices in longer-term competitiveness. On this basis, regaining financial self-rule and emerging securitised mindsets around finances fit well into the new economic policy patterns.

European stakeholders can hardly reverse these trends. Most of them stem from not only political factors but also structural ones, and the EU's own policies also point towards decreasing interdependence. The major question is how the sides can manage this process of mutual distancing. The West's efforts to use its economic leverage for political purposes currently dominates the economic agenda. At the same time, Russia's ambitions for strategic interference, including disinformation campaigns, overshadow political relations. Nonetheless, there is no visible longer-term alternative to the development of EU-Russia relations. The elaboration of a mutually acceptable plan for cooperation with reduced interdependence would be highly desirable. This could save some aspects of the relationship from the current freefall and potentially provide more instruments to manage confrontational situations.